STEPTOE & JOHNSON LLP

ATTORNEYS AT LAW

Collier Center
201 East Washington Street
Suite 1600
Phoenix, AZ 85004-2382

Telephone 602.257.5200
Facsimile 602.257.5299
http://www.steptoe.com

Patrick Derdenger
Telephone 602.257.5209
Facsimile 602.452.0929
pderdenger@steptoe.com

MEMORANDUM

July 30, 2003

TO: Citizens Finance Review Commission

FROM: Patrick Derdenger

RE: Throwback Rule

The throwback rule was repealed by the Arizona legislature in 1998, effective for taxable years beginning from and after December 31, 1997. See *Laws* 1998, 4th Spec. Sess., Chapter 3, Section 19. One of the proposals before the Citizens Finance Review Commission is the possible reinstatement of the throwback rule. This memorandum will address the policy and other considerations relating to the throwback rule.

I. Introduction to the Throwback Rule

In corporate taxation, the destination rule assigns income from sales of tangible personal property to the state for which those goods are destined.[1] There are two situations where reliance on the destination rule would leave corporate sales untaxed.[2] The first occurs when the destination state lacks the ability to tax the seller.[3] The second occurs when the goods are not destined for a particular state but to the U.S. government.[4] Income from these "nowhere sales"

[1] 1 John C. Healy & Michael S. Schadewald, *2002 Multistate Corporate Tax Guide* I-603, Panel Publishers (2002).

[2] James K. Smith, *Guide to State Corporate Income Tax Apportionment Part II*, 19 State Tax Notes 1645, 1646 (Dec. 18, 2000).

[3] *Id.* There are several reasons why a seller may not be subject to a corporate income tax in the destination state. These include the absence of a corporate income tax or the absence of a sufficient nexus between the corporation and the destination state. For example, P.L. 86-272 protects corporate income from state taxation unless that company has employees, property or does more than simply solicit orders in the state. Healy, *supra* n. 1, at I-604.

[4] Smith, *supra* n. 2, at 1646.

might remain untaxed but for an exception to the destination rule known as the throwback rule.[5] Under the Uniform Division of Income Tax Purposes Act ("UDITPA"), income from sales to the U.S. government or from sales to states that are unable to tax the seller, is thrown back for tax purposes to the state from which the goods originated.[6] The states are fairly evenly divided on the issue of adopting throwback rules.[7]

This memorandum examines the long term wisdom of either adopting or forgoing a throwback rule for corporate income. After exploring the policy considerations that underlie the throwback rule, this memorandum surveys the existence and administration of the throwback rule in Arizona and 10 competing states. In addition, the memo includes state legislative history and debate concerning the throwback rule where those materials are available. The objective of this survey is to provide information so that policy makers may consider the long term revenue consequences of reinstating the throwback rule on corporate income balanced against the competitive and economic stimulus benefits of not having a throwback rule.

II. Policy Considerations

"Nowhere income" is income that is not taxed by either the origination or the destination state.[8] In order to maximize nowhere income, a corporation with a significant percentage of sales going to the U.S. government may choose to locate in a state without a throwback rule.[9] Similarly, other corporations can completely avoid state taxation by locating in states without a throwback rule and then delivering goods to customers in states where the corporation is not subject to an income tax.[10] Because the absence of a throwback rule allows corporations to create nowhere income when selling goods to the U.S. government or to states unable to tax the corporation, repealing or not adopting the throwback rule is one way states can provide tax incentives to corporations that locate within their borders.[11] For this reason, commentators have

---

[5] *Id.*

[6] Healy, *supra* n. 1, at I-606. The pertinent UDITPA section reads:

> §16 [In-state sales of tangible personal property]
>
> Sales of tangible personal property are in this state if:
>
> (a) the property is delivered or shipped to a purchaser, other than the United States government, within this state regardless of the f. o. b. point or other conditions of the sale; or
>
> (b) the property is shipped from an office, store warehouse, factory or other place of storage in this state and (1) the purchaser is the United States government or (2) the taxpayer is not taxable in the state of the purchaser. UDITPA § 16 (2002).

[7] Healy, *supra* n. 1, at I-606.

[8] Smith, *supra* n. 2, at 1646.

[9] *Id.*

[10] *Id.*

[11] *Id.* at 1653.

observed that if there is a trend regarding the throwback rule, it is in the direction of eliminating it.[12]

In addition, states are progressively shifting towards a corporate tax apportionment formula that increasingly relies on the sales factor for corporate income.[13] As this shift occurs, states without a throwback rule may appear even more inviting as corporate locations.[14] For example, a study conducted in 1998 by Klassen and Shackelford found that in states that apply the throwback rule, corporations may attempt to avoid reporting sales if that state has also increased the weight on the sales factor.[15] Moreover, the study did not find this attempt by corporations when states did not apply the throwback rule.[16]

III. Revenue Impact

With respect to the 1998 legislation repealing the throwback rule, the Department of Revenue estimated the revenue impact to be approximately $5,000,000. The Department does not have a current revenue estimate of what any additional revenue would be if the throwback rule were reinstated.[17]

---

[12] Healy, *supra* n. 1, at I-606.

[13] Smith, *supra* n. 2, at 1652. Most states use a 3 part apportionment formula that includes property, payroll, and sales for determining the amount of tax a corporation owes and the trend is to put more weight on the sales factor. In addition, state legislators must establish the composition of the corporate income tax base in order to apply their apportionment formula. States usually do this by either a combined unitary reporting or a separate company reporting.

In a combined unitary reporting state, the state applies its apportionment formula to the combined income of related groups of corporations. For instance, a parent company and its subsidiary would simply file one combined return for state corporate income tax purposes. On the other hand, if the state applies separate reporting, the state will apply its apportionment formula to the parent and the subsidiary individually.

Complications may arise when a combined unitary state applies the throwback rule. For example, this state must choose whether the term "taxpayer" is determined on a corporation-by corporation basis within the related group or whether if one corporation within the related group is taxable in the destination state, all corporations within the related group are taxable.

The majority of states decide whether to throw back outgoing sales on a corporation-by-corporation basis for related, unitary groups (i.e. the "*Joyce* rule"). A minority of states allow unitary groups to escape throwing back the sales of related groups if one of the member corporations is subject to tax in the destination state (i.e. "the *Finnegan* rule"). *See Appeal of Joyce, Inc.*, 1966 Cal. Tax LEXIS 18 (St. Bd. of Equal. of Cal. 1966); *Appeal of Finnegan Corp.*, 1990 Cal. Tax LEXIS 4 (St. Bd. of Equal. of Cal. 1990).

[14] *Id.*

[15] *Id.* at 1650. This study looked at the relationship between a state's manufacturing sales during 1983 to 1991 and that state's corporate sales tax rate. The author cautions that the data used for the study came primarily from the 1980's, a time when few states had increased the weight on their sales factor. Moreover, the sales data used in this study was based on the point of shipment while the sales data included in the apportionment factor was based on the point of destination.

[16] *Id.*

[17] *See* Arizona Department of Revenue, Office of Economic Research and Analysis, CFRC "Short List" Proposals, 6/5/03.

IV. Multi-State Survey

A. Arizona

In 1998, Tax Relief Proposal S.B. 1007 repealed Arizona's throwback rule.[18] Before the passage of S.B. 1007, corporate sales to the U.S. government and to nontaxable states were thrown back to Arizona, comprising part of the sales factor of the Arizona corporate tax apportionment formula.[19] The net effect was an increase in the Arizona corporate income tax structure.[20] At the time the legislature was debating S.B. 1007, the Department of Revenue estimated that if the legislature repealed the throwback rule, state income tax collections would reduce by $4.0 million in fiscal year 1998-1999 and by $5.0 million for all subsequent fiscal years.[21] Nevertheless, the legislative history for S.B. 1007 reflects little specific debate concerning the repeal of the throwback rule.[22] For example, both the House and Senate versions of the bill reflected the same technical changes relating to the throwback rule.[23] Senator Bundgarrd, in particular, praised the tax cut package as one that would provide for high-wage job growth in Arizona.[24]

B. California

California's throwback rule is located at Cal. Rev. & Tax Code § 25135 (2003). California originally adopted the provision in 1966 and it is currently identical to the corresponding UDITPA provision.[25] In general, sales from California that are not taxed in

---

[18] Ariz. Rev. Stat. § 43-1146 (2003); revised by S.B. 1007, 43rd Leg., 4th Spec. Sess. (Az. 1998). Before Arizona repealed its throwback rule it followed the *Finnegan* rule as the combined method for reporting unitary groups. Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

[19] Final Revised Fact Sheet for S.B. 1007, 43rd Leg., 4th Spec. Sess. (Az. 1998).

[20] *Id.*

[21] *Id.*

[22] Minutes of Committee on Finance, S.B. 1007, 43rd Leg., 4th Spec. Sess. (Az. 1998). Senator Spitzer mentioned that state income from the throwback rule was subject to revenue sharing among the cities.

[23] *Id.*

[24] *Id.*

[25] The statute was last amended in 1994 when a provision for specifically including unprocessed timber as property was added and then repealed by its own terms in 2000. Cal. Rev. & Tax Code § 25135 (2003) (Notes: Former Sections).

In addition, in California, the double throwback rule applies to drop shipments. To avoid the throwback rule, California requires proof of taxability in the destination state or country. Healy, *supra* n. 1, at I-608.

California's throwback rule applies to sales to the U.S. government and California now uses the *Joyce* rule as its combined reporting method for unitary groups. *Id.* at I-614.

(Continued...)

another state are thrown back to California.[26] In addition, California automatically throws back sales to the U.S. government.[27] Historically, California has applied an automatic throwback rule for sales to the U.S. government because the destination of these mainly defense and aerospace related goods is usually unknown.[28] In 1999, S.B. 1081 would have repealed the throwback provision with respect to sales to the U.S. government in cases when it would be possible to determine the destination of those goods.[29]

According to the California Franchise Tax Board ("CFTB"), without the throwback rule for sales to the U.S. government, tracking the destination of sales would be both administratively difficult and a source for disputes.[30] For example, the government might take possession of a good in California but ultimately use the good overseas.[31] In addition, because negotiations for government contracts frequently take place in Washington D.C., some California legislators argued that a disproportionate number of sales to the government would show up as Washington D.C. sales.[32]

On the other hand, S.B. 1081 sponsors argued that the throwback rule was an "outdated policy" that encouraged corporations to locate warehouses and shipping facilities in other states.[33] Sponsors emphasized that the legislature should repeal the throwback rule to ensure that jobs are created and maintained in California.[34] In addition, sponsors argued that the throwback rule placed California at a competitive disadvantage because, according to a study by the

---

The *Finnegan* rule is used for income from years beginning on or before 4/22/99 and the *Joyce* rule for income beginning on or after that date. *Id.*; *See Appeal of Huffy Corp.*, 1999 Cal. Tax LEXIS 173 (St. Bd. of Equal. of Cal. 1999).

Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

[26] Cal. Comm. Analysis, S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999).

[27] *Id.*

[28] *Id.*

[29] *Id.*

[30] *Id.* In addition, according to the CFTB, if California had repealed the throwback rule in 1999, the state would have lost 113 million in 2000, 214 million in 2001, and 315 million in 2002.

[31] *Id.*

[32] Cal. Comm. Analysis, S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999).

[33] S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999).

[34] *Id.* Sponsors also argued that sales to the U.S. government often resulted in double taxation because of California's use of the double-weighted sales factor, which means that the "sum of the property and payroll percentages plus twice the sales percentages are divided by four to derive the percentages of the business total profit that is attributable to California operations." Cal. Comm. Analysis, S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999).

Legislative Analyst ("LAO"), most industrial states do not throwback U.S. government sales.[35] In fact, although California is among 28 states that focus on origin when apportioning corporate income from sales to the U.S. government, among the 10 leading states in terms of federal procurement, only 3 states use origin while the remaining seven use destination.[36] S.B. 1081 was supported by Oracle, Northrop Grumman, and Hughes Electronics but was opposed by the California Tax Reform Association and its status is now inactive.[37]

The LAO suggested two alternatives to repealing the throwback rule.[38] The first suggestion was that California single weight government sales.[39] This option would provide partial tax relief for California corporations, bring California into conformity with the majority of other states, and cause fewer complications relating to the administration and multi-state auditing activities of California's corporate tax.[40] The second suggestion was to zero weight government sales.[41] This would entail throwing out U.S. government sales altogether from both the numerator and denominator of the sales factor, which the LAO said would provide relief to companies and result in associated revenue reductions equal to about one half the amounts that would have occurred had California passed S.B. 1081.[42]

C. Colorado

Colorado's throwback rule is found under Colo. Rev. Stat. § 24-60-1301 (16) (2002). Although this statute mirrors the UDITPA throwback provision, Colorado's throwback rule does not apply to sales to the U.S. government.[43] In addition, Colorado is still reviewing what type of rule to use for the combined method of reporting unitary groups.[44] Finally, according to my research, the Colorado legislature has not specifically debated whether to repeal the throwback rule for sales destined to states where the seller is not taxed.

---

[35] Cal. Comm. Analysis, S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999). In 1999, the LAO presented findings and suggestions to the Senate Revenue and Taxation Committee concerning S.B. 1081.

[36] *Id.*

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] *Id.*

[41] Cal. Comm. Analysis, S.B. 1081, 1999-2000 Leg., Regular Sess. (Ca. 1999).

[42] *Id.*

[43] Healy, *supra* n. 1, at I-614. In addition, in Colorado, the double throwback rule does not apply to drop shipments. Furthermore, to avoid the throwback rule, Colorado requires proof of taxability in the destination state or country. *Id.* at I-609.

[44] *Id.* at I-614. Please see, *supra*, n.13 for an explanation of the *Joyce* and *Finnegan* rules.

D. Florida

Florida does not have a corporate income tax.

E. Georgia

At this time Georgia does not have a throwback rule. For this reason, Georgia is considered a favorable location for corporations that manufacture and sell tangible personal property.[45] In 1995, however, Georgia representatives Thomas B. Buck (D), Mary Jeanette Jamieson (D), and Jimmy Skipper (D), introduced H.B. 37, a bill that would have modified Ga. Code Ann. § 48-7-31 (d) (2) (C) so that sales of goods shipped from Georgia would be taxed in Georgia unless the destination state was able to tax the sale.[46] H.B. 37 did not expressly address sales to the U.S. government and it did not pass.[47] One reason the legislature may have decided against the bill is that it would have been unfair to impose the tax after inducing corporations to move to Georgia with the expectation that the state would not tax these sales.

F. Nevada

Nevada does not have an income tax.

G. New Mexico

New Mexico has adopted UDITPA and the throwback provision is located at N.M. Stat. Ann. § 7-4-17 (2002).[48] The throwback rule does not apply to sales to the U.S. Government and New Mexico applies the *Joyce* rule as its combined reporting method for unitary groups.[49]

H. Oregon

Oregon's throwback rule is found at Or. Rev. Stat. Ann. § 314.665 (2001) and it mirrors the provision in UDITPA. Furthermore, although the statute has been modified on four separate

---

[45] Michael T. Petrick, *Georgia Lawmakers Consider Throwback Rule*, 8 State Tax Notes 289 (January 23, 1995).

[46] *Id.*

[47] H.B. 37 1995-1996 Leg., Regular Sess. (Ga. 1995).

[48] Legislative Council Serv., *Index to Revenue Sources of New Mexico*, (January 2000). Available at http://legis.state.nm.us/misc/indextorevsour.html.

[49] Healy, *supra* n. 1, at I-616. In addition, New Mexico applies the double throwback rule for drop shipments. Moreover, to avoid the throwback rule the seller must prove taxability in the destination state or country. *Id.* at I-611. Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

occasions, none of the changes concerned Oregon's adoption of the throwback rule per se.[50] Oregon applies its throwback rule to sales to the U.S. government and Oregon applies the *Joyce* rule as its method for the combined reporting of unitary groups.[51]

I. Texas

Texas' throwback rule is found at Tex. Tax Code § 171.103 (2002). The rule was added to this section in 1984.[52] Because the statute discusses income from tangible property, intangible property, and services, it does not mirror the corresponding UDITPA provision. Moreover, the Texas statute does not expressly mention sales to the U.S. government.[53] Nevertheless, the Texas throwback rule applies to U.S. government sales.[54] In addition, Texas does not apply either the *Joyce* or the *Finnegan* rule for unitary groups.[55]

J. Utah

Utah's throwback rule is found at Utah Code Ann. § 59-7-318 (2003). The current version of Utah's throwback rule is worded exactly as the corresponding provision in UDITPA.[56]

---

[50] *See* H.B. 2203, 68th Leg., Regular Sess. (Or. 1995) (excluding income from incidental or occasional sales); H.B. 2624, 69th Leg., Regular Sess. (Or. 1997) (eliminating certain components of the sales factor portion of the formula used to apportion income to Oregon); S.B. 534, 70th Leg., Regular Sess. (Or. 1999) (eliminating more components of the sales factor portion of the formula); H.B. 2183, 72nd Leg., Regular Sess. (Or. 2003) (modifying the definition of sales used to apportion business income for income tax purposes).

[51] Healy, *supra* n. 1, at I-616. In addition, in Oregon, the state's double throwback rule applies to drop shipments and Oregon requires documentation to prove taxability in another state or country to avoid the throwback rule. *Id.* at I-611. Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

[52] *In Re: *** Corporation*, 1986 Tex. Tax LEXIS 459, *4 (Comptroller of Pub. Accounts of Texas 1986).

[53] The statute states that sales of "tangible personal property shipped from this state to a purchaser in another state in which the seller is not subject to taxation" will be thrown back to Texas. Tex. Tax Code § 171.103 (1) (2002).

[54] Healy, *supra* n. 1, at I-617.

[55] *Id.* In addition, in Texas the double throwback rule does not apply to drop shipments and the throwback rule does not apply to foreign sales. Moreover, in order for a corporation to avoid the throwback rule for its earned surplus, the corporation must prove it is incorporated in another state or that it is not protected from a net income based tax per P.L. 86-272. *Id.* at I-612.
Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

[56] In 1994 the legislature repealed a provision stating that sales of tangible personal property were not in Utah if the seller and purchaser would be members of the same unitary group except for the fact that either the seller or the purchaser was a foreign operating company and the goods were purchased for resale outside the United States. Utah Code Ann. § 59-7-318 (3) (1993).

Utah's throwback rule applies to sales to the U.S. government and Utah applies the *Finnegan* rule for unitary groups.[57]

K. Washington

Washington has no corporate income tax.

V. Concluding Remarks

According to one commentator, little data exists to determine whether repealing the throwback rule, and losing the apportionment of corporate income that comes from nowhere sales, actually leads to the location of corporations within those states and a corresponding production of long term growth.[58] On the other hand, as states compete with one another to lure corporations within their borders, abolishing the throwback rule is one method for delivering corporate tax incentives that states find increasingly attractive.[59]

[57] Healy, *supra* n. 1, at I-617. In addition, Utah's double throwback rule applies to drop shipments. To avoid the throwback rule the corporation must prove they have a nexus with the destination state. Utah's throwback rule also applies to sales to a foreign country unless the seller can prove taxability in the foreign state. *Id.* at I-613. Please see, *supra*, n. 13 for an explanation of the *Joyce* and *Finnegan* rules.

[58] Smith, *supra* n. 2, at 1649.

[59] *Id.* at 1653.